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Statement by Paul Filson, Director of Service Employees International Union (SEIU) Connecticut State Council in support of Raised Bill No. 6628 AN ACT CONCERNING TAX FAIRNESS. – Before the Finance, Revenue and Bonding Committee

Good morning, Co-Chairs, Senator Daily, Representative Widlitz and distinguished members of the Finance, Revenue and Bonding Committee - I appreciate the opportunity to be here before you today. My name is Paul Filson and I am Director of SEIU's Connecticut State Council. The State Council represents over 55,000 active members in Connecticut. SEIU is Connecticut's largest union. We represent health care workers, building service workers, state/municipal employees and community college professors and staff. SEIU advocates for a responsible, fair, reliable transparent and accountable taxation system for Connecticut.

In the past, corporate business income taxes accounted for up to 14% of all taxes collected. Today, that figure is closer to 4%. Connecticut corporations use a variety of accounting schemes to avoid paying taxes. While these schemes may be legal, their net effect has been to lower the net amount of taxes collected from corporations.

The Problem that Combined Reporting Solves:

State tax systems were crafted at a time when few businesses operated across state lines. With the exception of Hawaii and Alaska – both of which have combined reporting – the inherited architecture of state business taxes comes from a time when tax shifting with out-of-state subsidiaries was simply not an issue.

Over the years Connecticut businesses increasingly find themselves competing against or part of multi-state corporations with operations in multiple tax jurisdictions. That presents a quandary for assessing taxes on profits. Imagine yourselves some business with far-flung operations and subsidiaries. Revenue departments face the potential task of figuring out which costs and revenues should most accurately be assigned to particular corporate entities. Business executives argue among themselves over what operations should be considered cost drivers and profit centers, and they often change assessments year to year or quarter to quarter. Tax officials could not hope to accurately second-guess these assessments.

Thankfully, states created formula-based assessment. Companies pay taxes based simply on their in-state business activity. These formulas, which differ between states, require businesses to apportion their profits based on the percent of sales, assets and workforce in the state.

But out of state subsidiaries challenge this system by allowing some companies to use creative accounting to avoid paying their share of taxes. Four examples:

- **Inflated transactions** – Small-scale operations can be created in one of the few states without an income tax, like Nevada. The subsidiary may consult to its Connecticut operations, or it may own the land or equipment used by the Connecticut operation, for instance. If accountants for the Connecticut artificially inflated the value of these transactions, they will erase the taxable Connecticut profits and shift them to a jurisdiction where they can not be taxed.
- **WorldCom** – The telecom giant managed to avoid state taxes by creating what a court later determined was a sham subsidiary in Mississippi whose only asset was the "business foresight" of its WorldCom's top management. WorldCom then erased – on paper, at least – billions in taxable profits by having its Mississippi subsidiary charge its state operations billions in royalties for use of the foresight. The subsidiary did not pay taxes on these profits because income from intangible property is not taxed in Mississippi. WorldCom was not alone in adopting this tax strategy. It came at the recommendation of a leading

- accounting firm, KPMG. The facts only came to light because of a leak from some disgruntled WorldCom bond holders.
- **Toys 'R Us** – Similar to the WoldCom maneuver, the toy company greatly reduces its taxable profits because operations around the country large fees to pay a Delaware subsidiary for use of the "Baby Jeffrey" character and its logo. This intangible-property income is not taxable in Delaware where the subsidiary is based. Unlike the WorldCom strategy, this practice was declared legal by a judge after being challenged by the state of South Carolina.
- **Wal-Mart** – As documented recently in a front-page story in the *Wall Street Journal*, the retail giant largely escapes taxes by creating real estate trusts (REITs) that Wal-Mart stores use to erase their reported profits by paying it large rents. Real estate trusts are then exempt from paying taxes on this income. Wal-Mart claims to meet the legal requirement that a REIT have at least 100 independent shareholders because the company distributes 1 percent of its nonvoting stock to a group of 100 senior managers.

State tax authorities can not effectively police these forms of creative accounting. These examples come from court cases that have brought the practices to light. But more generally, state tax authorities are at a loss to second-guess the true value of transactions between corporate subsidiaries. Legislatures can pass laws to close particular well-understood loopholes, such as the Baby Jeffrey loophole. But the legislative process is slow and tax authorities can not keep up with the booming industry of consulting and banking firms that constantly invent – and sometimes even patent – new tax avoidance techniques. State tax authorities do not, and perhaps should not, have the resources and authority it would take to keep up with these accounting shell games. Tax authorities are simply outgunned.

2) How Combined Reporting Works

California was the first state to create combined reporting in 1937. California decided to get out of the business of outfoxing corporate tax lawyers, rather than sorting through transactions between subsidiaries and trying to establish which might be sham transactions and whether they reflected the true corporate structure of these entities. Companies with subsidiaries were simply asked to file together as a single entity.

With combined reporting the question of which subsidiary should be assigned particular profits or losses becomes moot. Transactions between corporate subsidiaries similarly need no longer be scrutinized. The combined entity's profits will still be apportioned to the state and taxed based on its in-state business activity. Some states such as Texas and Ohio have enacted combined reporting on gross receipts taxes instead of corporate income taxes because these are their alternative form of broad business tax. The effect is the same: to bypass the effects of any accounting fictions created through the use of out-of-state subsidiaries.

Moreover, as an increasing number of states enact combined reporting, companies can use more or less the same spread sheet for each state. Any multi-state company should know the breakdown of its sales, assets, and workforce by state anyway. Combined reporting is a form of tax simplification.

3) Combined Reporting is Becoming Standard Best Practice

States across the nation have begun fighting back against corporate tax shelters and loopholes. Nearly half the states in country have adopted combined reporting and all of Connecticut's neighbors have. Adopting combined reporting does not put Connecticut at a competitive

There is a growing awareness that these loopholes are not necessarily good for business. Arnold Hiatt, former CEO of Stride Rite shoes in Massachusetts, wrote to the *Boston Globe* that tax reforms including combined reporting, "would benefit our state's business community by leveling the playing field among businesses." Although most tax-avoidance strategies are perfectly legal, they disproportionately benefit larger companies that work across multiple states. As a result, smaller in-state businesses find themselves at a competitive disadvantage.

Another factor driving reform has been support from elected officials who face additional revenue needs and understand that closing tax loopholes will make it possible to avoid levying new taxes. In the context of our huge budget deficit, the failure of multi-state companies to pay taxes has put elected officials in a double bind. They have fewer dollars available to meet public needs, while smaller companies and the citizens who elected them have been forced to pick up the tab. For that reason it is reasonable to enact combined reporting and to pass **6628**